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PROBLEMS IN APPRAISING SERVICE STATIONS

WE would like to offer in this bulletin some of our recent thinking and methods used in our approach to appraisals of service stations. This type of property has always been among the most difficult for which appraisers have to establish fair market values. Difficulties arise, not only because of the special-use characteristic of service stations, but also because of the highly competitive nature of the oil industry.

We all recognize service station properties as being income-producing, retail, drive-in and of the convenience type of commercial real estate. It is also evident that the owners of the service station property, the operators, and the oil companies profit from this type of operation. There can be no question that the tremendous growth of automobile ownership has changed the very pattern of our cities and our personal living. Likewise, we must accept this firmly entrenched method of gasoline and oil distribution through service stations. As far ahead as we can see, automobiles and trucks are here to stay.

In recent years there has been a tendency of the oil companies to develop larger volume stations and at best possible locations in order to secure high-volume sales. This has been brought about by the high cost of building stations and relatively high land acquisition costs. It is also important to remember that an oil company that is not represented in a particular area already served by competing stations may be anxious to locate in this area and will pay a premium for a good location. Furthermore, oil companies must continue to develop and maintain good outlets for their products, as that is the only way they can continue to grow and prosper.

Another factor to consider in the overall picture is that in different locations some oil companies will be in a better position than others because of proximity to their refineries or to a gasoline pipe line that serves their company. Such favorable locations reduce their distribution costs, and they can afford to pay a higher premium to the owner of the real estate or to assume less profit on their own stations in order to secure high volume.

The market value of a service station property is, of course, dependent upon a number of things. Ultimately this value is established by its income-producing potential in the future. However, in order to determine this probable income stream, there are many factors to consider. Under the general heading of access

must be included an analysis of the size, shape and grade of the lot, the placement and size of improvements, the neighborhood potential, visibility, volume and compatibility of traffic, transient business, potential competing stations, and what future trends may be evident for that area.

Brand acceptance is another factor which enters into the value of a service station; another is the operation of the station. This latter factor might be called operator appeal, which includes service, management, advertising, incentives and customer good will. The hours of operation of a station, number of employees and especially the operator's personality and position in the neighborhood are very important.

A station does not have to have a high rating in all of these factors to be successful. We know of one station in a residential area on a small, inadequate site with an old building, with very little transient business potential, but which at the same time is doing a volume of 60,000 gallons a month because it has a monopolistic factor due to strict zoning, is located in a neighborhood of rapid growth, and is operated by a man with tremendous drawing power.

As we see it, there are four basic types of service station operations with which the appraiser is confronted. First, there is the station owned and operated by an individual who buys his products from an oil company. Secondly, there is the station owned by an oil company which leases to an operator. Thirdly, there is the station owned by a party other than an oil company and leased to an operator. Lastly, we find the station owned by one party, leased to an oil company, which in turn leases to an operator. We have found variations of these four types, but generally this breakdown covers the field.

In using the three approaches to real estate value - namely, the comparative, summation and income - the appraiser is faced with several problems. First, in using the comparative approach it is unusual to find a sale of another operating service station in the vicinity of the appraisal. Usually, the appraiser can find sales of land in the vicinity of the subject site, but often the land value of the service station will exceed the surrounding land values indicated except in high-volume retail districts. When the summation approach is used, the reconstruction cost of the improvements, added to a land value arrived at by a comparative approach, often falls considerably short of the value of the service station property. It is the income approach which should be the best measure of the value of service stations, and it is this approach which we will discuss in the following paragraphs.

In appraising the type of service station owned by an individual and leased either to an operator or to an oil company, the income approach should work quite well, as it is the income stream from the actual rentals of the property which will be processed. A word of caution here, however, would be that the appraiser must analyze the operation of the station to see if it is being used effectively and the maximum potential realized. Some adjustment might have to

be made in the income stream because of a poor operation or because of an operation which is unusually good. By the latter we mean, for example, a one-man station where the operator who leases the ground and buildings is willing to devote 14 hours or more a day himself, 7 days a week, to produce a high volume.

Generally, stations owned by oil companies are leased to operators at a rental that averages about 1¢ a gallon. Oil companies operate on the basis that in order to get a good operator and to get a good outlet for the distribution of their product they are willing to assume the difference between a realistic rental for the property and the 1¢-a-gallon figure. In other words, today it takes 2¢- or as high as 2½¢-a-gallon rental to economically justify the cost of the land and the modern service station improvements.

Let's take, for example, a retail price of regular gasoline of 26.9¢. The operator, whether leasing from the oil company or owning the station himself, pays 21.7¢ a gallon for this gasoline. The difference - 5.2¢ - is the operator's gross. From this he must pay a 1¢ real estate rental as well as the operating expenses of his station. The oil companies, instead of realizing their full profit on the sale of gasoline at 21.7¢ a gallon, are willing to take 1 or 1½¢ less profit in order to get a good outlet for their products and a high volume of sales.

In using the income approach, then, on these two types of stations - the one owned and operated by an individual and the other owned by an oil company and leased at a nominal rental to an individual - we must assign a fair economic rental in order to reflect a true value of the property. In our opinion, this rental today would be up to 2 to 2½¢ per gallon. The only other alternatives as we see it would be to lower the capitalization rate or to extend the life of a building to as much as 40 years instead of something like 20 or 25 years. There is some reason for lowering the capitalization rate because major oil companies, as the owners of such real estate, are large billion-dollar corporations and can borrow money at rates far less than the average real estate investor can. There is also some justification for extending the building life to as much as 40 years, as a well-located station of good construction could easily have an economic life that long. However, we are familiar with many corners which were formerly occupied by service stations but which are now being used for a wide variety of lesser uses. Because of the risk and the competitive nature of the oil business, we usually hesitate to lengthen the economic life beyond 25 years.

Oil companies, the largest purchasers of service stations, in order to get distribution of their products have adopted the policy of assuming a portion of the real estate cost despite the fact that they lease it to an operator at what is commonly referred to as a fair current rental. Major oil companies would prefer not being in the real estate business but have found it necessary in order to get increasing distribution of their products.

The appraiser must carefully analyze the terms of any existing lease on the real estate, for if the lease is unfavorable to the owner, the value of the real

estate so encumbered decreases in proportion to the length of time the lease has to run. It therefore naturally follows that a short-term lease has relatively little effect on the value of the property. It also follows that a premium or discount must be applied to the value, based upon the favorable or unfavorable characteristics of the lease.

In the event of a lease unfavorable to the owner, the discount from the value would be the present worth of the loss in rental for the period the lease has to run, while the premium in the case of a lease favorable to the owner would be the present worth of the additional rental that could be secured during the remaining term of the lease.

In subsequent bulletins we will present sample appraisals of service station locations and various construction cost data.